QUESTION PRESENTED

Whether the taxpayer, filing its corporate income tax returns on the accrual basis, realized taxable income in 1952 as a result of a bookkeeping transfer from a liability account to earned surplus of an amount representing patent royalty expenses accrued and deducted from taxable income in prior years but never actually paid to the patent licensor.

STATUTES AND REGULATIONS INVOLVED

Pertinent provisions of Section 446 of the Internal Revenue Code and of Section 1.446–1(c)(ii) of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix to the petition (Pet. App. 16a–18a).

STATEMENT

Petitioner is a corporation engaged in the manufacture and sale of automotive testing equipment. In 1937, it entered into a contract with General Motors Corporation whereby it agreed to pay to General Motors a royalty for using certain patents for headlight testers which petitioner intended to manufacture and sell. Petitioner commenced manufacturing the headlight testers in 1937 and paid some royalties, but a dispute arose in 1938 and petitioner refused to make farther payments. From 1939 through 1948, petitioner nevertheless annually accrued on its books and deducted on its corporate income tax returns the unpaid royalty liabilities, which by 1948 totalled $129,889.66. Throughout this period, petitioner's taxable income

was in excess of the amounts so deducted, and it thus gained a tax benefit from the deductions. (Pet. App. 2a, 6a–7a.)

Petitioner continued to accrue and deduct the royalty liabilities for the years 1949 through 1952. In 1953 the Internal Revenue Service disallowed the deductions for those years on the ground that the expenses were contingent and uncertain. No questions were raised as to the propriety of the deductions taken for years prior to 1949. (Pet. App. 2a.)

Petitioner retained the 1939–1948 accrued royalty liabilities on its books of account and certified financial statements until 1962. As of December 31, 1962, petitioner adjusted its books, eliminating the liability and increasing its retained earnings (earned surplus) by $129,889.66. Since that amount previously had been deducted from income but never paid, the Internal Revenue Service determined that it represented income for the taxable year 1962 and assessed a tax deficiency of $67,542.62. Petitioner paid the deficiency and commenced this suit for refund in the district court, which upheld the assessment. (Pet. App. 3a, 7a–10a.)

On appeal, the Seventh Circuit affirmed, holding that the bookkeeping transfer in 1962 marked the termination of the liability. It rejected petitioner's contention that the taxable event occurred in an earlier year, when the local statute of limitations had allegedly barred a claim by General Motors. (Pet. App. 3a–5a.)

ARGUMENT

The decision below turns essentially on the facts of this case and is correct. There is no conflict of decisions or any other reason for further review.

1. It is generally acknowledged that the return or recovery of property once the subject of an income tax deduction must be treated as taxable income in the year of its return or recovery, unless the initial deduction did not result in a tax saving. *Rothensies* v. *Electric Battery Co.*, 329 U.S. 296; *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399 (Ct. Cl.). Thus, an accrual basis taxpayer who properly deducts an expense which subsequently is not paid, realizes income in the year the liability terminates—that is, the year in which *all* events have occurred which are necessary to fix the right to receive the income and make it possible to compute accurately the amount actually realized. Treasury Regulations on Income Tax (1954 Code), Section 1.446–1(c)(ii).

Petitioner does not dispute these "tax benefit" principles and concedes that they are applicable to this case (Pet. 4). Nor does petitioner deny that it received a tax benefit as a result of deducting, but never paying, patent royalties to General Motors (Pet. 6). However, petitioner contends that, in applying the tax benefit principles to the facts of this case, the lower courts erred in concluding that income was realized in 1962, the year the expense was transferred from its liability account to earned surplus. It contends that the income was actually realized no later than 1959, when the Illinois statute of limitations allegedly barred

legal action by General Motors to enforce the patent royalty agreement. The court of appeals properly rejected this argument, stating (Pet. App. 4a) that "[t]he expiration of the period in which actions may be brought to recover the unpaid expenses from the taxpayer does not necessarily mark the practical termination of that liability."

None of the decisions cited by petitioner support its argument that the running of a local statute of limitations conclusively fixes the point when an accrual basis taxpayer must restore an accrued but unpaid liability to taxable income. Indeed, this factor is seldom controlling, whether it occurs prior or subsequent to an objective manifestation by the taxpayer that the liability will not be paid. *North American Coal Corp.* v. *Commissioner*, 32 B.T.A. 535, affirmed, 97 F. 2d 325 (C.A. 6); *G.M. Standifer Construction Corp.* v. *Commissioner*, 30 B.T.A. 184; *Policy Holders Agency, Inc.* v. *Commissioner*, 41 T.C. 44. While it may affect a creditor's remedy in a court of law, it does not extinguish the debt. A taxpayer may retain a liability on its books of account after the statute has expired for any number of practical business considerations.

The governing rule, which was followed by the court below, requires consideration of all of the facts and circumstances in determining the point when a liability has terminated. Elimination of the liability on the taxpayer's books of account, if (as was the case here) it clearly manifests an intention never to pay the debt and to use the previously earmarked funds for general business purposes, is often accepted as persuasive

evidence that a liability has terminated in the year of such bookkeeping adjustment. *Chicago R.I. & P. Ry. Co.* v. *Commissioner*, 47 F. 2d 330 (C.A. 7); *Wichita Coca Cola Bottling Co.* v. *United States*, 152 F. 2d 6 (C.A. 5).

2. Petitioner's reliance (Pet. 13–14) on *Studebaker-Packard Corp.* v. *United States*, 61–2 U.S.T.C., par. 9331 (N.D. Ind.), and *Pittsburgh Industrial Engineering Co.* v. *Commissioner*, 9 T.C.M. 1132, is misplaced. Neither decision set forth any legal standard for determining when an accrued, but unpaid, liability terminates. Moreover, in both cases the taxpayer had taken an improper deduction in a prior taxable year, while here the deductions for the years 1939 through 1948 were admittedly proper when taken. *Policy Holders Agency, Inc.* v. *Commissioner*, *supra*, also cited by petitioner (Pet. 14–16), does not support its contention. The Tax Court explicitly held in that case (41 T.C. at 49) that "[s]tate statutes of limitations, while of evidentiary value, are not determinative of the factual question of when income is realized." At all events, any conflict between the decision below and the district court and Tax Court cases upon which petitioner relies does not warrant review by this Court.

Contrary to petitioner's assertion (Pet. 16–17), there is no conflict with *Commissioner* v. *Mnookin's Estate*, 184 F. 2d 89 (C.A. 8), and cases following it. Those cases, which involve facts wholly different than

those here, state the general principle that the Commissioner may not tax in one year income that rightfully belongs to an earlier taxable year. The courts below applied that principle in this case. They determined, after considering all the facts and circumstances, that petitioner's liability to General Motors was terminated as a practical matter in 1962, with the result that petitioner realized income in 1962. The record amply supports that determination.

Finally, the decision of the court of appeals is in harmony with the general principles of accrual method accounting enunciated by this Court in *Spring City Co.* v. *Commissioner*, 292 U.S. 182. There, the Court held that a taxable event occurs for an accrual basis taxpayer upon the crystallization of the right to receive income, and not upon a prior expectation or subsequent receipt. But there is no "crystallization" until all the events have occurred necessary to fix the right to receive income which can be accurately calculated. In the instant case, the crucial taxable event did not occur until petitioner manifested its intent not to pay the liability and asserted dominion and control over the corresponding sum for its own corporate purposes. Even though petitioner clearly hoped that General Motors would never assert a claim for the unpaid royalties, it did not actually assert control over the funds until it made the bookkeeping transfer in 1962. It follows that income was not realized until 1962.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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